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Of all the rude awakenings that the bear market in stocks has brought to investors, perhaps the most jarring has been the realization of how woefully wrong Wall Street's research analysts have been this year on the stocks they follow. While the market sank to its worst performance in more than a decade, many of those analysts kept right on smiling and saying "buy." How can so many who are paid so much have blown it so spectacularly for their investor customers?

"How Did So Many Get It So Wrong?" *The New York Times,* Dec. 31, 2000

BUST

Don't look at the details of fourth-quarter 2000 U.S. GDP growth. It will rob you of your sleep if you still hope that a serious slump can be avoided. It has arrived with a vengeance. Real GDP increased by a miserable $32 billion, annualized. But the most salient point that everybody conveniently ignores is the source of this growth: consumer spending, up $44.8 billion; government spending, up $11.4 billion; inventories, up $67.1 billion. If you deduct these components from the record increase of the aggregate, you discover an economy that is racing into deep recession. Heavy inventory building and consumer spending has been the economy's main prop. But there, too, some snags have to be taken into account. Consumer spending has actually slowed sharply, but compared to collapsing fixed capital investment it was still strongly positive, contributing 1.92 percentage points to the fourth-quarter growth rate of 1.4%. But to keep up this sharply lowered spending, the consumer had to step up his borrowing because the growth of his real disposable income has virtually vanished. In the fourth quarter, it was only a meager 0.5% at annual rate, after 2.6% in the prior quarter. Personal saving went a big notch deeper into negative territory, from 0.2% to 0.8% of disposable income.

The disaster is really happening in two areas: consumer durables and fixed capital investment. Obviously, the consumer has reached the point where he has to take on more debt just to pay for services. Spending on durables is sharply down. The overwhelming cause of the economy's slump is a steep downturn in corporate fixed investment spending. It was negative 0.30 percentage points, as against a positive contribution of 2.68 percentage points in the first quarter of last year. Spending on equipment and software was down 4.7%, compared to plus 20.6% in the first quarter. High tech investment was still positive with an increase of 9.6%. But coming from a stellar growth rate of 31.4% in the first quarter, it nevertheless reflects a steep decline.

On Jan. 3, the Fed's Federal Open Market Committee board unleashed its whopping 50 basis point rate cut on an unsuspecting financial world. The announcement came in the middle of the day, just when stocks were beginning to accelerate to the downside and several stock indexes were threatening to break below crucial price supports. Wall Street responded with the most explosive rally in history. More thoughtful observers could only wonder how bad the economic and financial situation must be to induce the Fed to such dramatic action, smacking strongly of panic.

Taken completely unaware by the Fed's rate shock, many economists have been wondering whether Fed Chairman Alan Greenspan knows of some specific, dangerous event in the economy or the financial markets that is not evident to everyone else. We think this is an idle question. Economists who had not noticed anything frightening on the economic front until then must have been asleep at the wheel. As pointed out in recent letters, the fourth quarter reading on the overall U.S. economy has been a small disaster for some time. Several economic indicators have slumped to their lowest levels since the recession of 1990-91. Few economists, though, were willing to read the message.

IT'S STILL GENERAL DENIAL

Mr. Alan Greenspan has gained the gloriole of being the world's greatest central banker who has

masterminded the U.S. economy's longest expansion with record-high economic growth and has contained inflation. We hardly need to emphasize that we have a radically different view of what he has achieved: the world's worst bubble economy in history, riddled with financial excesses and economic imbalances of unprecedented magnitude.

For years we have been warning that this "bubble" and "bubble economy" will end like all their predecessors: in a devastating bust. A few times in the past, it seemed that the day of reckoning was at hand. During the 1990s, Mr. Greenspan had to cope with two critical phases, one in 1990-91, involving a recession, and the other one in September-November 1998, when Russia's default on a bond issue sent heavy jitters through the U.S. financial markets, jeopardizing the Long-Term Capital Management hedge fund. Fearing that the unwinding of truly monstrous commitments of LTCM in assets and derivatives markets would endanger the important institutions involved, the Fed orchestrated the rescue of LTCM and slashed its interest rates in swift succession by 0.75% — with quick success.

Now the Fed is facing its greatest outstanding challenge in the whole postwar period, we think. Most economists are looking hopefully back to 1998, when the Fed easily pulled the economy through the crisis with its three small, though quick, rate cuts, convinced that the same medicine will work as well and as fast as it did in 1998. "Look across the valley" is Wall Street's happy invitation to investors. Many believe that the U.S. economy may experience a sharp downward lurch, but thanks to rapid Fed easing, it is expected to be a brief, painless affair. Propelled by a few rate cuts, investors can look forward to a "V-shaped" economic recovery in this year's second half and a new boom in the stock market. Sleep well in the meantime.

Recession has arrived in the United States. Now the critical question is, how deep and protracted will the developing downswing be?

A RERUN OF 1998? FORGET IT

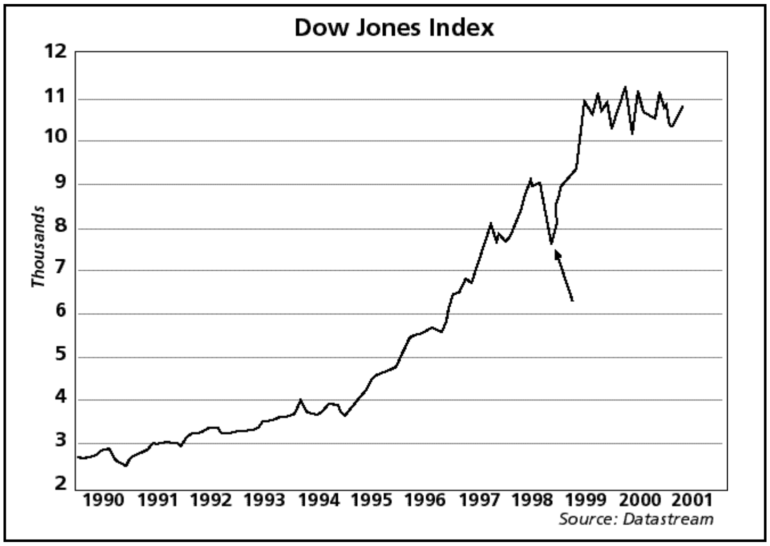
It is on record that of the nine recessions that America has experienced since World War II, America's leading "experts," including the President's Council of Economic Advisors and some 50 members of the Blue Chip Consensus, have foreseen not one. The last case in point was the recession of 1990-91. On Aug. 21, 1990, the Federal Reserve Board's policymakers gathered for one of their periodic meetings to set interest rates. Unknown to them, the economy was already in recession. "*Those who argue that we are already in a recession, I think, are reasonably certain to be wrong,*" Mr. Greenspan told his colleagues. Since the economic slowdown developed very gradually, the recession was not effectively recognized until it was five months old, which was one reason the Fed waited rather long to cut its interest rates.

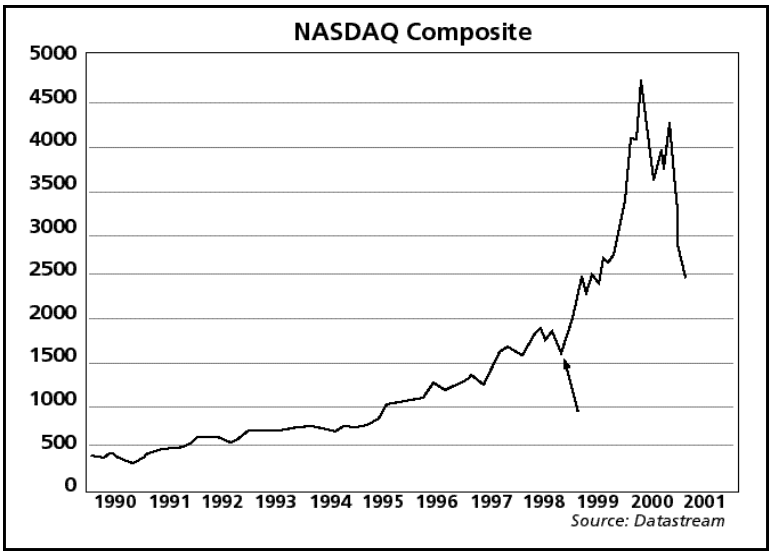
While Mr. Greenspan's recent remark of a "*very dramatic slowdown*" in the economy was certainly apt to shock people, Wall Street economists, trained to metamorphose any bad news into good news, gave this disastrous fact a totally different twist: Economic weakness is good because it compels the Fed to another big rate cut. Actually, the big rate cut buttressed the financial markets and even the dollar.

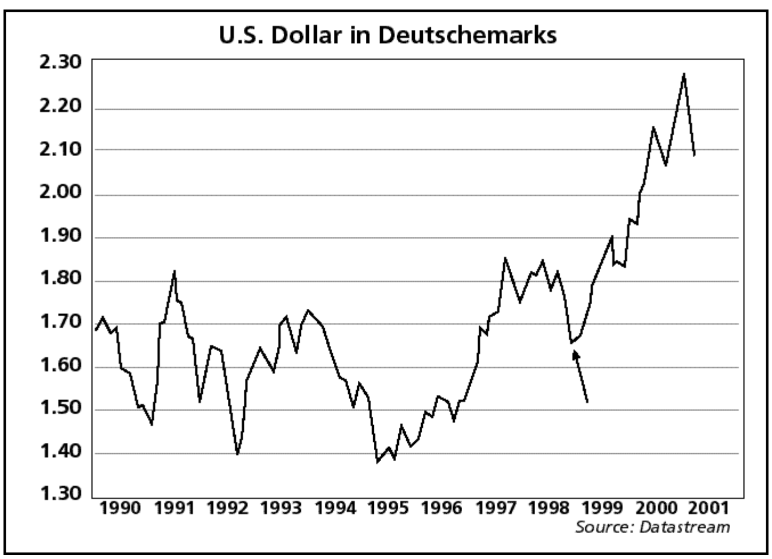
Despite the burst of the technology bubble and mushrooming credit problems, there remains the overall notion that nothing really bad can possibly happen to the U.S. economy. It begins with the assumption that it has no serious problem, except for the lagged effects of the Fed's rate hikes between June 1999 and May 2000, and it ends with the assumption that, in any case, Mr. Greenspan stands ready to counter any weakness in the economy with immediate, aggressive action, adding liquidity and lowering rates. Not only that, there is moreover an overwhelming conviction not only of Mr. Greenspan's determination in this respect but also of his ability to achieve what he wants. Didn't it work magnificently in 1998? Apparently, this happy memory of highly successful Fed magic in the past is playing quite an important role in banishing any gloomy thoughts about the U.S. economy in the present. In short, confidence in the Greenspan Put reigns supreme.

Yes, the Greenspan Put worked marvelously at the time. Why won't it work this time? In short, because U.S. economic conditions today differ from those in 1998 like day and night.

While the consensus admires Mr. Greenspan for what he did and achieved in 1998, we have, after thorough







reconsideration of conditions and events at the time, come to the very opposite conclusion: Easing back then was his greatest and most fateful policy blunder entailing disastrous consequences for the U.S. economy. In order to understand this devastating verdict, it is necessary to look at the economic and financial development during the following two years.

Money and credit expansion went exponential. Excesses and imbalances already in place were exacerbated with a vengeance: stock prices soared vertically, personal saving collapsed and the trade deficit exploded. Virtually everything in the economy and the financial system went completely out of control. In short, excesses went to unprecedented extremes. Look at the charts.

TWO KINDS OF RECESSION

While American economists like to equate the present economic and financial situation in the United States with that in the fall of 1998, we think it has to be looked at as a “post-bubble” period, much like the post-1929 period in the United States and the post-1989 period in Japan, although economic weakness need not be anywhere near as severe. This assessment hinges on the famous postulate of the Austrian School that the crisis is the inevitable consequence of the credit excesses and the economic and financial maladjustments that have accumulated during the preceding boom, and that the bust’s severity is broadly proportionate to the extent of the excesses and imbalances that have accumulated during the boom. Therefore the long and deep crisis in America during the 1930s and also the present, prolonged deep crisis in Japan.

It’s a proposition that most American economists hotly dispute. In particular under the influence of Milton Friedman, it has become their consensus view that the Great Depression was the result of the policy errors that followed after 1929. Though the Fed slashed its interest rates

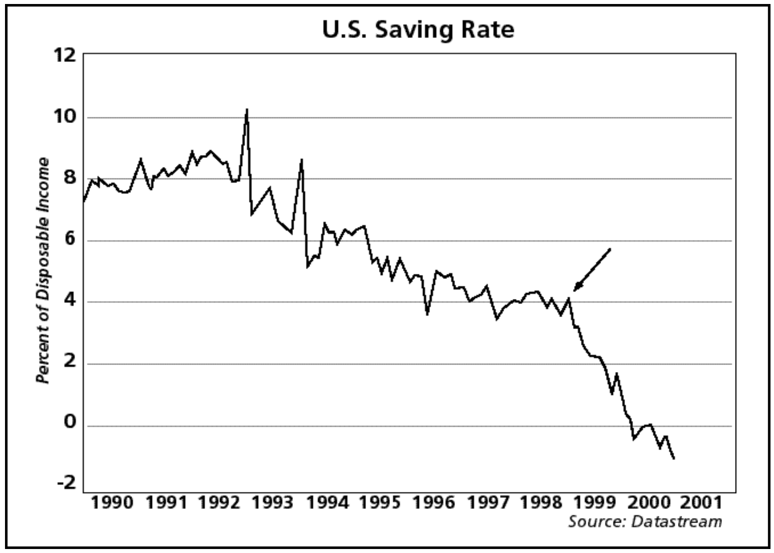
instantly, it is accused of having pursued, in reality, an exceedingly tight monetary policy, as evidenced by a rapidly shrinking money supply. Similarly, Japan's current, endless, economic and financial malaise is explained with the fact that the central bank was too slow in lowering its interest rates.

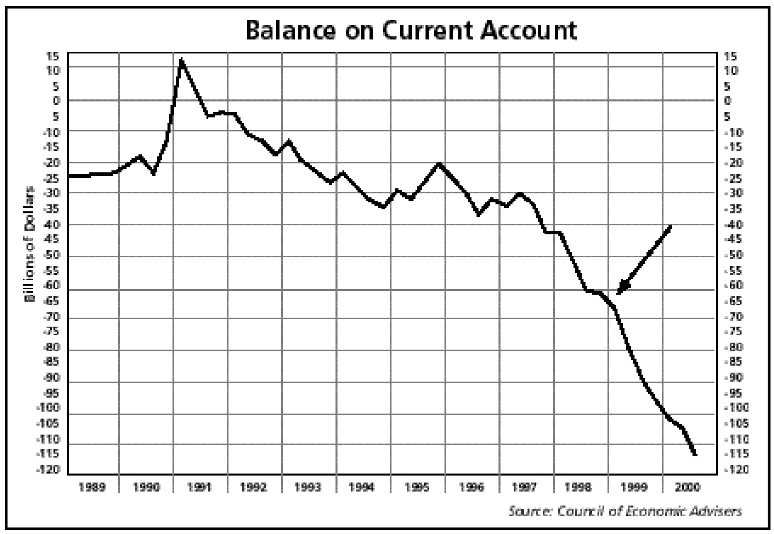
In our view, the conception of the Austrian School has a compelling logic. The essence of any recession or depression is that businesses and consumers have to correct unsustainable spending excesses they have perpetrated during the boom. The typical postwar recession in industrial countries is centered on the correction of excessive inventories built up during the boom. Ensuing recessions could be sharp, but were always brief. Once the inventory adjustment had run its course, the economies took off again, not so much because of lower interest rates but because the necessary inventory adjustment process had been accomplished.

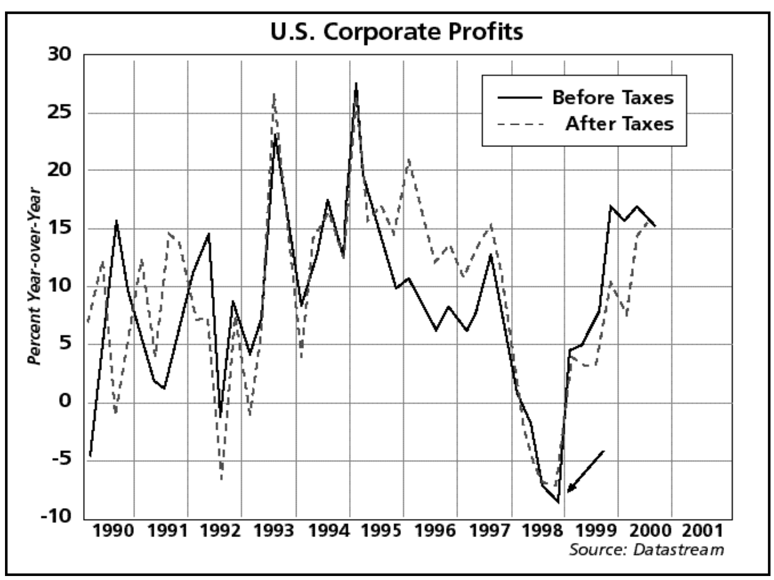
1991: AMERICA'S FIRST "POST-BUBBLE" DOWNTURN

Fearful and protracted economic and financial trouble looms when the spending excesses during the boom happen on the level of final demand, that is, in consumer spending and capital investment, both residential and non-residential, and also involve soaring indebtedness of consumers and corporations. Historically, the worst excesses of this kind have typically occurred in association with more or less pronounced asset price bubbles, as the soaring asset prices provide the collateral that facilitates and fosters the borrowing binge.

When the bubble bursts and asset prices plunge in the face of persisting high debt levels, the implicit ravaging of balance sheets impels borrowers as well as lenders to greater prudence and measures to readjust their balance sheets. Correcting the maladjustments pervading the whole economy and the financial system intrinsically requires an adjustment process far more protracted and painful than the







regular inventory correction. Recessions of this kind, involving dramatic changes in financial structures, might be specified as "post-bubble" or "balance sheet" downturns. In essence, the boom gives way to recession *and* financial crisis.

America had its first postwar encounter with this type of recession in 1990-91. It was different from all prior recessions in two ways: first, the boom-related excesses had their brunt not in inventory excesses but in huge malinvestments in commercial real estate; and second, it was not tight money imposed by the Fed that caused the credit crunch, but soaring bad loans that paralyzed the banking system and the financial markets. Nightmare images of the Great Depression began to haunt top Fed policymakers.

It was plunging commercial real estate prices that set the pace of the financial crisis and the economic downturn. The market for mortgage-backed securities narrowly averted a major disruption. In February 1990, junk bond king Drexel Burnham Lambert went under. Remember, several hundred billion dollars were required to bail out the depositors of banks and S&L's. For well over a year, Citibank's fate hung in the balance. In December 1991, regulators put it on the nation's list of 1,071 "problem" banks that were most likely to fail.

In the course of 1991, the Fed slashed its discount rate by five half-point cuts from 7% to 4.5%, its lowest level since the 1960s. Yet the economy refused to respond. On Dec. 19, 1991, Mr. Greenspan, in obvious desperation, took his boldest move, cutting the discount by a full percentage point to 3.5%. Still, it wasn't over. On July 7, the discount rate was cut to 3% and the federal funds rate guided down to that floor benchmark. This compared, by the way, with an inflation rate in consumer prices of 3-4% at the time.

Actually, the size of the downturn was not at all unusual. What was unusual was the economy's persistent refusal to respond to the Fed's drastic monetary easing. As a result, the U.S. economy's annual rate of real GDP growth during the first half of the 1990s averaged only 2.2%. It was the weakest showing for America in the whole postwar period. Business borrowing stagnated for three full years. In May 1995, the dollar fell to its lowest level against the European currencies, hitting DM 1.35

This dismal experience had far-reaching consequences for monetary policy. Disappointed with the economy's poor performance, the Fed left its discount rate at its rock-bottom level of 3% from early July 1992 to mid-1994. Inherently, the next wave of rate hikes, from May 1994 to February 1995, which pushed the discount rate up to 5.25%, started from an extremely low level. Yet in early 1996, the Fed cut its rate again to 5%, even though the economy was showing strong and accelerating growth. Apparently, Mr. Greenspan wanted stronger growth. While businesses took the bait of the record-low interest rates with unusual hesitation, financial investors quickly seized the opportunity. The Great Stock Market Boom that was to follow really started at the beginning of 1995.

To repeat: The U.S. recession in 1990-91 was America's first "balance sheet" or "post bubble" recession, in contrast to prior "inventory recessions." What kind of recession is presently unfolding? During his brief comments on the economy in his Jan. 25 congressional testimony, Mr. Greenspan said bluntly that, "*we are observing the beginnings of what is probably a major inventory correction.*" His biggest concern, according to reports, is that this *inventory correction* will severely jolt the confidence of consumers and businesses.

If one thing is absolutely clear about this recession, it is the fact that businesses have been piling up inventories at a record rate right until the end of last year. All the weakness in spending has exclusively arisen from consumer spending and business spending on fixed capital. Looking for a parallel, we focus on the "post bubble" or "balance sheet" recession of 1990-91 as a rather mild case of this genre. Considering, though, the singular magnitude of prior credit excesses, expect something much worse this time.

ODD GREENSPAN WISDOM

Mr. Greenspan has presided over three outstanding and unique achievements: *first*, the longest U.S. economic expansion; *second*, the world's biggest credit bubble; and *third*, the world's most rampant stock market boom in history.

We have never made a secret of our growing misgivings about him. His public speeches and congressional

testimonies keep appalling us by their shallowness in matters of money and credit. Apparently, he has not the faintest idea of the difference between excess and efficiency of the financial system. During a hearing in the House Banking Committee in Congress on the LTCM bailout, some Representatives accused him of rescuing a "run-amok, casino-like enterprise, driven by greed." Mr. Greenspan riposted with a statement on these institutions as valuable contributors to the efficiency of the markets, saying:

> *I am scarcely defending hedge funds. But many of the things they do in order to obtain profit are largely arbitrage-type activities — buying in one market in order to sell in another — which tend to refine the pricing system in the United States and elsewhere, and it is that really exceptionally and increasingly sophisticated pricing system which is one of the reasons why the use of capital in this country is so efficient. It is why productivity is the highest in the world…I am not saying that all this great prosperity is the consequence of hedge funds. Obviously, not. What I am saying is that there is an economic value here which we should not merely dismiss.*

In other words, the hedge funds, with their fantastic leverage, in Mr. Greenspan's view, play an important role in assuring and promoting a highly *"efficient allocation of capital"* in the U.S. economy. That's not only a defense of hedge funds, that's an outright eulogy. Frankly speaking, it makes us sick. To give our riposte in brief: In an economy where money and credit creation is so preposterously in excess of economic activity, there is, intrinsically, a massive misallocation of resources taking place.

On this very subject of controlling the money supply, Mr. Greenspan actually made a very shocking remark in late January 2000 during his Humphrey-Hawkins testimony. Referring to the literal explosion of broad money in the fourth quarter of 1999 that Mr. Greenspan had unleashed with big injections of bank reserves and the alleged intention to counter any Y2K accident, one committee member, Dr. Ron Paul, reproached him about talking too much about prices and labor costs without saying a word about the tremendous growth in money.

In his answer, after having extensively rambled about the complexity of measuring money, Mr. Greenspan answered that the Fed had, therefore, downgraded the use of monetary aggregates for monetary policy purposes, stating: *"The problem that we have is not that money is unimportant, but how we define it*." Dr. Paul: *"So it's hard to manage something you can't define?"* Mr. Greenspan: *"It is not possible to manage something you can't define*."

It should no longer be a mystery, especially not to a central banker, why booms and busts come about. Their inexorable common denominator is credit excess. America's central bankers in the 1920s worried about the inordinate credit expansion fueling the boom in the economy and the stock market, and so did Japan's central bankers in the late 1980s. The credit excesses in the United States under Mr. Greenspan are many times worse than those in these two bubble periods, yet he displays total indifference to what is happening in the financial system, except when it begins to show strains. Then he is all-alert.

More to the point, not only did he recklessly foster unprecedented money and credit excess through incredible monetary largess, he systematically stoked the speculative furnaces with his glowing descriptions of the economic miracles that the new technology and the new American capitalist model were imparting to the productivity and the speed limit of the U.S. economy.

Asset bubble and bubble economies are driven by excess credit. In reflecting whether or not the booming stock market was a "bubble," Mr. Greenspan stated in his July 1999 Humphrey-Hawkins testimony:

> *Should an asset bubble arise, or even if one is already in train, monetary policy properly calibrated can doubtless mitigate at least part of the impact on the economy. And, obviously, if we could find a way to prevent or deflate emerging bubbles, we would be better off. But identifying a bubble in the process of inflating may be among the most formidable challenges confronting a central bank, pitting its own assessment of fundamentals against the combined judgment of millions of investors.*

From the world's leading central banker, this is an unbelievable statement, virtually confessing that he can't have better judgment than the "crowd" in the market. Mr. Greenspan has the reputation of being a most meticulous number-cruncher. In this respect, he is certainly not alone in America. Statistical research in the United States traditionally enjoys far greater interest than theoretical conception. Take Monetarism — it is pure

statistics and zero theory.

NUMBER-CRUNCHING

It's not by chance that America has by far the most elaborate economic and financial statistics, but in general it is number-crunching without theoretical guidance. Actually, this has been the striking contrast between America and Europe for time immemorial, where the battle of wits in economics has always been about theoretical conceptions. Still, it seems to us that this narrow-minded statistical approach has gone to an unprecedented extreme in the United States in the 1990s. Theoretical macroeconomic thinking is completely out. America's leading economists after World War II, by the way, were immigrants from Austria, and they are badly missing today.

To quote Friedrich Hayek on this matter: *"On the whole, the practical value of statistical research depends primarily upon the soundness of the theoretical conceptions on which it is based. To decide upon the most important problems of the Trade Cycle remains the task of theory."*

Thanks to lack of any theoretical conception,American economists readily discard the monstrous U.S. trade deficit and the steep plunge of personal saving as irrelevant to the economy's health. Having done no harm in the past, why should they do so in future? Quite a few even hail the trade deficit as an emblem of economic strength and dynamism. Since these people are just as illiterate in history as in theory, it is obviously unfamiliar to them that high-growth economies typically run a surplus in their current account, such as America in the 1920s, Germany in the 1950-80s and Japan until the late 1980s. And that has an intrinsic cause: a high level of domestic saving. Implicitly, healthy high-growth economies have high saving and investment ratios, making for a high supply of goods and for exports.

Mr. Greenspan considers it impossible to identify an asset price bubble before it bursts. Yet credit theory of all schools of thought has a precise answer to this dilemma: The source and measure both of an asset bubble and a bubble economy, as of any other kind of inflation, is credit excess. Established credit theory further says that a credit expansion is "excessive" to the extent that it exceeds available current saving. By this measure, there is nothing but credit excess at work in the U.S. economy and its financial system.

To be more specific: The runaway boom in the stock market had two main sources. One was massive purchases of stocks by the corporations through mergers, acquisitions and buybacks, overwhelmingly financed by credit creation. And the other one was a massive shift in portfolio holdings on the part of private households away from liquid deposits and into illiquid stocks. In the jargon of monetary theory, it might be called a collapse in the demand for money. More compelling evidence of the existence of an asset bubble is not conceivable.

INFLECTION POINT 1998

We come to the financial crisis of 1998. Under the shadow of the Russian crisis, culminating in the crisis of the LTCM hedge fund, expectations about the U.S. economy had turned more and more gloomy in the course of the year. It seemed to be coming under the threat of a credit crunch and a corporate profit squeeze. Within a few months, credit quality spreads in mortgages and high-yield (junk) bonds had surged to their highest level since the 1990/91 recession. New-issue financing in some sectors had come to a virtual halt. The Dow index had lost almost 20% within six weeks. An unusual aspect of the turmoil was that it happened without a prior tightening in monetary policy. According to Mr. McDonough, chairman of the New York Fed, *"the developing financial crisis had the potential to become the worst in the post-World War II period."* That didn't happen, in part because the Fed's prompt rate cuts succeeded in containing the crisis. On Oct. 15, the Fed hastily applied the second rate cut, signaling that more would follow until market liquidity was restored. Wall Street rallied and credit spreads sharply narrowed.

Apparently, this particular experience has done a lot to enhance Mr. Greenspan's reputation as the central banker who can easily master any crisis. At the time it was generally argued that with the huge commitments of LTCM — more than $100 billion in assets and about $1.4 trillion in derivatives — the viability of the whole U.S. financial system was at stake, supposedly presaging a sharp slowdown of the economy.

In this light, Mr. Greenspan's rescue operation looked like a great achievement. The recession that many had feared never materialized. But in our view, an assessment of this episode should begin with some highly critical questions about Mr. Greenspan and the U.S. financial system. The atrocious leverage that surfaced with LTCM suggested that the U.S. financial system was completely out of control, lacking any reasonable restraint. What's more, authorities, lenders and investors had minimal or no knowledge of the existing astronomical financial leverage. Instead of praising Mr. Greenspan for his rate cuts, he should have been blamed as the person primarily responsible for such a rotten financial system. In actual fact, he has played a key role in fending off proposed measures that would require corporations and financial institutions to disclose their off-balance-sheet positions.

A RECESSION THAT NEVER WAS

With the benefit of hindsight, the crisis in the autumn 1998 appears in a very different light today. In reality, the U.S. economy never slowed down. Quite the opposite, its growth sharply accelerated from 2.9% in the second quarter and 3.4% in the third quarter to 5.6% in the fourth quarter, all at annual rate. Mr. Greenspan was successful in fighting a recession that never existed. Nor was there any true credit crunch. America experienced its greatest credit deluge ever. True, corporate borrowing had temporarily slowed in the third quarter, but over the whole year the credit expansion gathered unprecedented speed. Consumer debt growth jumped from $345.8 billion in 1997 to $488.1 billion (up 41%), and business debt growth from $379.3 billion to $527.1 billion (up 39%). Though breathtaking on both counts, it was vastly eclipsed by the borrowing binge on which the financial sector embarked in 1998, boosting its new borrowing from $635.7 billion in 1997 to $1,073.9 billion (up 69%).

Absent any credit restraint or economic slowdown, the rate cuts obviously had their true cause in nothing but full-fledged panic on the part of Mr. Greenspan and the Wall Street elite about LTCM. While the Fed's measures may have prevented something worse, the record-breaking credit excesses that immediately followed and the emergence of record-breaking imbalances in the economy (see the charts on pages 3-4) ought to have set alarm bells ringing in the Fed. Instead, it waited far too long to reverse the crisis-related rate cuts.

Looking at those charts, 1998 clearly stands out as an inflection point in the development of the U.S. bubble economy. After 1998, the prevailing excesses and developing imbalances went to new, historic extremes.

2000-2001 — WHAT NOW?

A closer look at the events in 1998 makes it abundantly clear that any comparison between then and today is grossly misplaced. There was a single problem in 1998: market jitters stemming from the LTCM affair. They coincided with buoyant consumer and investment spending, both of which were picking up strongly. To say that the Fed's three rate cuts prevented recession is utterly absurd. It stoked up an already accelerating boom. Ironically, the Asian crisis produced substantial windfall gains for the U.S. economy, among them a sharp decline in headline inflation which, in turn, led to sharply accelerating real income growth, more than offsetting the income losses from lower exports to Asia. To repeat: Looking for an economic situation comparable to the present one, the focus should be on the "balance sheet" recession of 1990-91.

As already mentioned, the ominous thing about the U.S. economy's present slowdown is both its stunning speed and its unusual pattern, starting with investment and consumer spending, while inventories surge. Taking everybody by surprise, the U.S. GDP in the second half of 2000 had its slowest annualized gain since 1996, just 2.2% in the third quarter and 1.4% in the fourth quarter. The consensus readily ascribes it to lagged effects of the Fed's tightening between mid-1999 and mid-2000. In terms of "free reserves" — equaling excess reserves minus discount window borrowings — the Fed's policy stance, however, has been extremely loose for some time.

For the consumer, credit could hardly be looser so far, and, as described, he keeps frantically making use of it. Helped by huge purchases of mortgages on the part of the government-sponsored enterprises (Freddie Mac, etc.), mortgage rates have plummeted. According to Freddie Mac's weekly survey, the average 30-year fixed mortgage rate has plunged to 6.89%, the lowest level since the spring of 1999 and way down from a peak of 8.54% in mid-May. The result has been a steep rise in mortgage refinancing applications, quadrupling since May 2000. As we have explained in past letters, the American consumer is not starving for credit; he is starving for

real disposable income growth.

CAPITAL SPENDING IN NOSEDIVE

Watching the burst of the IT bubble in stock markets, we have been looking for sharply lower high tech spending. It started after a burst of spending in the first quarter of last year. But, of course, one can be right for the wrong reason. One dirty little secret of the rapidly fading tech boom in 2000 is a rapidly waning hedonic price component, reflecting the fact that measurable improvements in computer power are shrinking. For several years, this "hedonic" adjustment had added as much as 30% per year in the real GDP account to every dollar effectively spent. Lately, it has slipped to about 10%.

Nevertheless, corporate investment outlays have also sharply slowed in current dollars. We wanted to clarify this point because it warns that the overdue decline in corporate investment spending has barely started. Indeed, the quarterly Federal Reserve flow of funds statistics shows that the corporate sector's "financing gap" — excess of investment spending over internal cash flow — rose to a fresh all-time high of $216 billion in the third quarter, compared to $105.4 billion in 1995. These spending numbers, by the way, relate exclusively to outlays on fixed investment and inventories, not to the huge purchases of financial assets.

It makes no economic sense, but the main reason for the corporate debt surge is that most of the new debt has been used to buy back stock to boost shareholder value by "managing" higher earnings per share.

For a bunch of reasons, the retrenchment in capital investment is unfolding with a vengeance. Mainly two things induce corporate management to slash their investment spending: a profit squeeze and a credit squeeze. Here, too, one has to wonder about the speed and the broadness of the deterioration. One generally unappreciated reason is the bearish stock market, considering that reported corporate earnings in the last few years were massively bolstered both by gains in the stock markets.

This worked mainly in four major ways: *first*, massive stock buybacks; *second*, sale of equity investments, particularly by high tech firms; *third*, extensive use of stock options as a substitute for cash wage payments that would have to be expensed in the profit-and-loss account; and *fourth*, huge gains on the stock holdings of corporate pension funds virtually replacing corporate cash contributions. Together, all this added massively to reported corporate earnings — as long as stock prices rose. It seems to us a foregone conclusion that the sudden drastic deterioration in the profit picture has an important reason in the fact that the end of the bull run in stocks has abruptly deprived corporations of these formerly opulent profit sources.

The intrinsic conclusion: For all the talk about radical restructuring, flexible labor markets and miraculous productivity effects of the new technology, Corporate America's profit performance would have been outright miserable in the past few years without the huge windfall gains from the booming stock market. As to profits and profitability, the new paradigm economy was one great Wall Street conceit.

THE PROFIT BOOST OF 1998-2000

While painful evidence of a rapidly weakening U.S. economy abounds, consensus forecasts for GDP as well as profit growth remain as rosy as ever, reflecting the general hope for a "V-shaped" recovery. Our diametrically opposite view that U.S. corporate profits are poised for a prolonged, steep fall basically derives from the realization that two major profit-killing forces are unfolding with a vengeance.

For a start, we have to go back once more to the years 1997-98. As to the U.S. economy's performance, they ought to be remembered for three things: *first*, for the jitters in the financial markets due to the Asian-Russian-LTCM crisis; *second*, for a sudden, significant decline in profit growth; and *third*, for the Fed's easing and the unprecedented excesses that followed in the economy and the financial system. Please take another look at the six charts on pages 3-4. Earlier, we labeled the year 1998 as the "inflection point" in the U.S. bubble economy because after the Fed's easing at the time "everything in the U.S. economy and its financial system went completely out of control."

What, exactly, was it that sent profits soaring again after their lull in 1998? In past letters, we have

repeatedly explained the macroeconomic approach underlying our assessment of profit prospects: We focus on the particular flows that directly increase or decrease business revenues, on one hand, and business expenses on the other. In hindsight, the new boost to U.S. corporate profits during the last two years arose from two flows in particular. One was rising investment spending, and the other was the sharply accelerating run-down of personal saving.

We have pointed out before that net capital investment is typically the major profit source in a capitalist economy. The main reason for this profit effect is that investment spending — looking at the business sector as a whole — produces a corresponding increase in overall revenue, while the related expenses in the form of depreciation charges are incurred gradually and with delay. It was a basic proposition among Keynesians that "*workers spend what they earn and that capitalist earn what they spend*." As investment spending has in the last two years increased much faster than depreciation charges, it was a major profit source for the business sector.

Nevertheless, this profit boost from higher investment spending pales in comparison to the boost from the steep decline of personal saving into negative territory. Consider that consumer purchasing power has two different sources: current income and credit. All current income derives from current production, and that means, from the expenses of the business sector. In contrast, the borrowed money that the consumer spends on goods and services, coming straight from the credit machine, increases the business sector's revenue without incurrence of any expenses.

Measured by its fall, the American consumer in the last two years (1999-2000) has spent about $300 billion in excess of his current income. In contrast to consumer spending out of current wages, this represents for the business sector a net increase in total revenue that has involved no expense. It is sheer profit. Of course, it's anything but a healthy and sustainable profit source. However, the ballooning trade deficit and the increasing budget deficit are major drags on profits by diminishing revenues.

WHO OR WHAT KILLED THE BOOM?

There is a spreading view now that Mr. Greenspan and his colleagues have killed the economy's longest postwar expansion with their rate hikes in 1999-2000. On closer look, this sudden, sharp economic slowdown has several causes, but Fed tightness is clearly not among them. First of all, its spigot of bank reserves has been wide open, and credit for the consumer has remained abundantly available, with mortgage rates even falling. What increasingly ails the consumer, as we have repeatedly stressed, is not lack of credit but lack of real income growth, and rate cuts are sure to slow it further.

An entirely different case is businesses' fixed capital spending. Funds from external sources such as banks, credit markets and the stock market have dramatically shrunk in the course of 2000. But who or what is responsible? While the Dow has faltered and the Nasdaq went into a steep slide, the credit spreads of high-yield corporate bonds began to soar. A rapidly growing part of U.S. corporate bonds now ranks as "junk." Most issues are now untradeable. Bank lending to the corporate sector has diminished to a trickle, unlike in 1998 when it

CREDIT EXPANSION (IN $BILLION)

	1998		1999				2000		
	III	IV	I	II	III	IV	I	II	III
BUSINESS	472.3	518.1	718.8	467.2	599.6	579.1	617.8	701.1	387.5
CONSUMERS	472.3	535.9	562.7	526.4	589.5	513.6	534.7	650.4	564.8

Source: Federal Reserve, Flow of Funds Accounts of the United States

AND ITS EFFECTS (IN $BILLION)*

PERSONAL SAVING	224.8	227.5	204.5	163.5	121.2	100.9	10.9	20.6	-17.3
CURRENT ACCOUNT	-245.2	-247.8	-286.6	-321.1	-340.4	-367.5	-376.8	-403.4	-425.0

* *annualized numbers*

Source: Department of Commerce, Survey of Current Business.

soared. Major banks warn about sharply rising nonperforming loans, particularly industrial and commercial loans. Meanwhile, signs of sharply rising pressure on U.S. businesses to retrench are everywhere, particularly in a rapidly developing profit squeeze, evidently jeopardizing access to new financing across the whole financial system.

But the great, yet generally unappreciated, problem is that this bad profit news is coming from a corporate sector that has systematically devastated its balance sheets for years, resorting to very reckless leveraging to boost profits per share. Over the past five years, American corporations have bought back a net $2.7 trillion-worth of their equity.

POISED FOR A PROFIT MELTDOWN

A reasonable assessment of Corporate America's profit prospects in the foreseeable future boils down to the question of impending changes in revenue flows, on one hand, and expense flows on the other. First, however, a general remark: Although Mr. Greenspan's gift of rate cuts implies a first cost reduction, the widespread view that this is sure to rekindle the recovery is all too simplistic. As earlier explained, the tightening of corporate credit appears to owe far more to lower profits and the bad shape of corporate balance sheets than to Fed policy. Please keep in mind, though, that this systematic devastation of balance sheets in the name of higher shareholder value has its cause not in the Fed's rate hikes of 1999-2000 but in the prolonged monetary looseness and inordinate credit excesses of the years 1995-2000. No serious crisis has ever come from tight money, but always from loose money.

While the Fed's rate cuts may well help the financial markets, at least for a while, their importance for the economy is generally grossly overrated. Consumer borrowing, in any case, is still in excess of current income, and the corporate credit crunch has obviously other, more important, causes. The present crucial, negative influence on corporate investment spending is the profit outlook, and that is disastrous as far as the eye can see. Saying this, we have in mind two foreseeable changes in revenue flows in particular. One is the impending inventory correction, which, in contrast to Mr. Greenspan's remarks, has not even started. It is sure to hit 2001 with full force. Yet we would rank something else as the biggest negative influence on the economy and on potential profits in the foreseeable future, and that is the inevitable reversal of personal saving from negative to positive. Consider the terrific financial squeeze facing the American consumer for a long time to come: virtual zero real income growth and prolonged wealth destruction in the stock market. In due time, he will have to retrench dramatically.

And how will all this affect capital investment by the business sector? Be sure, disastrously.

Also, given a slowing world economy there is no hope for an export-driven recovery. Besides, exports are simply too small a component of the U.S. economy for such a solution. That leaves one single plank to grab at: a big tax cut. In brief, what counts, of course, is not the tax cut as such but the increase in spending that it triggers. In our opinion, the forces working imminently toward the contraction of consumer and business spending are grossly underrated.

THE DOLLAR MENACE

If a reversal in personal saving is the death sentence for economic recovery, a plunging dollar would devastate the U.S. financial markets. The dollar has fallen more than 10% against the euro, but considering the Fed's drastic rate cuts and all the terrible news about the U.S. economy, the resilience of the U.S. currency appears rather astonishing. Still, it has a quite obvious reason. We notice a distinct difference between the reporting about America's and Europe's economy. Modestly bad news about Europe gets overblown publicity while the terribly bad news about the U.S. economy is grossly under-reported. Instead, the focus is overwhelmingly on the Fed's aggressive action and the strong recovery that the economy, in response, is supposed to stage in the second half of this year.

Yes, U.S. rates will come down rapidly, but these more rapid rate cuts should be regarded as the Fed's desperate response to an economic situation that is deteriorating with unprecedented speed. What's more,

behind this downturn is neither tight money nor a shallow inventory correction. It is deeply rooted in massive, unsustainable distortions both in economic and financial structures that have accrued during from at least five years of the most egregious credit excesses ever perpetrated in history.

Looking back, the appreciation of the dollar played a vital role in the unprecedented bull run in the stock market as well as in the stellar growth of the economy. The stable and rising dollar was indispensable in attracting ever-larger capital inflows, and at the same time it assured the Fed's monetary looseness by keeping a lid on inflation. It was not just the expectation of superior returns on U.S. stocks and corporate bonds that enticed European investors and lenders into the United States but also the hope of an appreciating currency.

But of these attractions nothing is left. Assessing the future dollar-euro rate, it is our long-held opinion that the dollar will tank, rather than the euro rally. But of all those factors that made the dollar attractive in the past absolutely nothing is left. What's more, everything goes dramatically into reverse.

Meanwhile, there is wide agreement that the dollar will fall further against the euro. But by how much is the great question. Expecting no more than a brief inventory correction and a rapidly following "V-shaped" recovery for the U.S. economy, the consensus sees the euro peaking at around $1.05 sometime later in the year — before falling back again. To us, this currency forecast is notorious for the prevailing gross illusions about the U.S. economy's inherent strength and the nature of this economic downturn.

CONCLUSIONS

The impending U.S. recession should basically be seen as a repeat of the 1990-91 "post bubble" or "balance sheet" recession. But the underlying economic and financial imbalances strangling the economy are far worse today. Therefore, the impending recession will run much deeper and last far longer than the consensus expects. Excess of confidence is its last and final excess.

Once people begin to realize the extraordinary severity of the unfolding recession, the false confidence will, after all, collapse — with dramatic effects, particularly on the stock market and the dollar. For the reasons explained, we expect the deepest and longest postwar recession in the United States.

American policymakers, like most economists, expect no more than a gentle depreciation of the dollar, reflecting a gentle recession. Seeing the worst postwar recession unfolding in the United States, we expect the dollar to fall to a new postwar low against the European currencies. That would be around DM 1.30, compared to presently DM 2.07.

A serious dollar crisis, cutting off capital inflows, would badly hit both U.S. stocks and bonds, putting long-term dollar bonds at risk. The dollar-based investor, who switches into euro bonds, can look forward to a very big currency gain. In order to make the same currency gain, the European investor would have to borrow dollars and switch them into euro with which he buys euro bonds. It costs the minimal short-term interest rate differential.

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